

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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to: Susan Delisle  
Revenue Agent  
( )

from: Diane D. Helfgott  
General Attorney, (Newark, Group 2)  
(Large Business & International)

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subject:

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
State	=
Life Insurance Company Subsidiary	=

ISSUE:

Whether any part of the increase in reserves in Year 4 for the annuity rider is an adjustment due to a change in basis in computing reserves that should be taken into account under section 807(f) of the Internal Revenue Code?

CONCLUSION:

The difference between reserves computed as of the end of Year 4 computed without taking into account the proper application of AG 33, and reserves computed as of the end of Year 4 taking into account the proper application of AG 33 is a change in basis subject to section 807(f).

FACTS:

Taxpayer is the parent of a life-nonlife consolidated group that includes two life insurance companies. The adjustment at issue concerns Life Insurance Company Subsidiary (LIC), a State domiciled company.

LIC markets annuities as part of its product line. Starting in Year 1, LIC started marketing a rider to the annuities ( ) that would provide for a benefit. The rider is described as a

The primary statutory reserve guidance for the is *Actuarial Guideline 33, Determining CARVM Reserves for Annuity Contracts with Elective Benefits* (AG33). The statutory rule for the valuation of annuities is the Commissioners Annuity Reserve Valuation Method (CARVM), but AG33 contains some clarifications on the processes to be used when there are multiple optional benefits included in either the annuity form or in riders attached to the annuity form.

In performing statutory reserve valuations for calendar years Year 1, Year 2 and Year 3, the company understated its statutory reserve liability due to the use of incorrect for parts of the rider features. As a result of the understatement, the taxpayer did not report a reserve for the rider in Year 1 and Year 2. The taxpayer reported a reserve for the rider of \$ on its Year 3 annual statement. The understatement was corrected (with state regulatory approval) in the Year 4 calendar year, with the company reporting an increase in statutory reserves of \$ at the beginning of Year 4 due to a change in computing the understated reserve at year end Year 3. The company reported this increase as a change in valuation basis on line 43 of the Summary of Operations (as an adjustment to surplus).

For tax years Year 1, Year 2 and Year 3, the tax reserve was equal to its statutory reserve. In addition, its tax reserve was calculated using the statutory reserve method as used in those years, using the interest rate assumptions reflected in the understated statutory reserve calculations. Thus, on taxpayer's Year 1, Year 2 and Year 3 tax returns, taxpayer reported \$ reserves, \$ reserves, and \$ reserves, respectively, because the tax reserve was limited to the understated statutory reserve per section 807(d)(1). In Year 4, the taxpayer filed amended tax returns for Year 2 and Year 3. The taxpayer claims it recomputed its tax reserves under section 807(d)(2) to



correct for the improper application of AG 33 for Year 2 and Year 3 per the amended returns. However, there was no change to the amount of the tax reserves reported for the rider because the tax reserve was still limited per section 807(d)(1) to the understated statutory reserve. Taxpayer notations indicate the tax reserves at year end Year 3 were calculated correctly under AG33, but the tax reserve held for determination of Year 3 taxable income due to growth in reserves was properly limited to the statutory ceiling, or in other terminology, the statutory cap. Thus, the ending reserve balance, and the amount of the deduction for increase in reserves, did not change. Because the ending tax reserves did not change, the taxpayer did not report an adjustment due to a change in basis in computing reserves.

On its originally filed Year 4 tax return, the taxpayer calculated its tax reserves with the proper . Because there was a change in the computation of the statutory reserves to take into account the proper application of AG 33, the taxpayer's tax reserves for the rider were no longer subject to the statutory reserve limitation. Thus, tax reserves using the proper pursuant to AG33 were reflected in the final reserve computation. In Year 4, the taxpayer's reserves increased from \$ to \$ . Of that amount, \$ was attributable to the application of the change in to the Year 3 year-end balance, and the remaining amount was attributable to the current year increase in reserves when reserves were consistently computed as of the beginning and end of the year. The taxpayer did not consider any portion of the reserve increase as a change in basis. It recognized the increase in reserve in full as a deduction in Year 4.

#### LAW AND ANALYSIS

Section 805(a)(1) includes in general deductions all claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts.

Section 805(a)(2) includes in general deductions the net increase in reserves which is required by section 807(b) to be taken into account under this paragraph.

Section 803(a)(2) includes in gross income each net decrease in reserves which is required by section 807(a) to be taken into account under this paragraph.

Section 807(a) provides that if for any taxable year the opening balance for the items described in subsection (c), exceeds the closing balance for such items, reduced by the amount of the policyholders' share of tax-exempt interest and the amount of the policyholder's share of the increase for the taxable year in policy cash values (within the meaning of section 805(a)(4)(F)) of life insurance policies and annuity and endowment contracts to which section 264(f) applies, such excess shall be included in gross income under section 803(a)(2).

Section 807(b) provides that if for any taxable year the closing balance for the items described in subsection (c), reduced by the amount of the policyholders' share of tax-



exempt interest and the amount of the policyholder's share of the increase for the taxable year in policy cash values (within the meaning of section 805(a)(4)(F)) of life insurance policies and annuity and endowment contracts to which section 264(f) applies, exceeds the opening balance for such items, such excess shall be taken into account as a deduction under section 805(a)(2).

Section 807(c) provides that the items referred to in subsections (a) and (b) includes the life insurance reserves (as defined in section 816(b)).

Section 807(d)(1) provides that for purposes of this part (other than section 816), the amount of the life insurance reserves for any contract shall be the greater of --

807(d)(1)(A). -- the net surrender value of such contract, or

807(d)(1)(B). -- the reserve determined under paragraph (2).

In no event shall the reserve determined under the preceding sentence for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves (as defined in paragraph (6)).

Section 807(d)(2) provides that the amount of the reserve determined under this paragraph with respect to any contract shall be determined by using the tax reserve method applicable to such contract, the greater of the applicable Federal interest rate or the prevailing State assumed interest rate, and the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

Section 807(f)(1) provides that, for purposes of this part, if the basis for determining any item referred to in subsection (c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between --

807(f)(1)(A)(i). -- the amount of the item at the close of the taxable year, computed on the new basis, and

807(f)(1)(A)(ii). -- the amount of the item at the close of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account under the method provided in subparagraph (B).

Section 807(f)(1)(B)(i) provides that if the amount determined under subparagraph (A)(i) exceeds the amount determined under subparagraph (A)(ii), 1/10 of such excess shall



be taken into account, for each of the succeeding 10 taxable years, as a deduction under section 805(a)(2).

Section 807(f)(1)(B)(ii) provides that if the amount determined under subparagraph (A)(ii) exceeds the amount determined under subparagraph (A)(i), 1/10 of such excess shall be included in gross income, for each of the 10 succeeding taxable years, under section 803(a)(2).

Section 807(d)(1) provides a "three prong test" for determining the amount of the life insurance reserve for any contract. The reserve is first computed using the tax reserve computation required by section 807(d)(2) (hereinafter, "federally prescribed reserve" or "FPR"). The reserve is then increased, if the net surrender value of the contract is higher. Finally, the reserve is reduced, if applicable, so that it does not exceed the amount of the statutory reserve. The final amount so determined is the amount of the life insurance reserve at the end of the year, and the difference between the ending balance at the end of the year and the ending balance at the end of the prior year is the amount of the deduction or increase in income.

In the instant case, the taxpayer changed its method of computing the FPR in Year 2 when filing an amended return, but due to the statutory reserve limitation, the change did not affect the amount of the tax reserve until a parallel change was made in the method of computing statutory reserves in Year 4. See Rev. Rul. 94-74, 1994-2 C.B. 157. The issue in this case is whether a change in basis subject to section 807(f) occurred in Year 4.

There is no dispute that a change in the computation of reserves to take into account the factors required by AG 33 is a change in basis subject to section 807(f). See Rev. Rul. 2002-6, 2002-1 C.B. 460. The issue is whether that change in basis occurred in Year 4 when Taxpayer changed its method of computing the statutory reserves limitation or "cap."

The taxpayer contends that the change in basis attributable to AG 33 occurred when the taxpayer filed its amended returns in Year 2 and Year 3. The taxpayer claims that the only method of accounting involved in the computation of the tax reserve is the method of computing the FPR without regard to the statutory reserve limitation (or, presumably, the net surrender value floor). It characterizes the application of the statutory reserve limitation as a mere limitation or cap on the tax reserve accounting method. It argues that there is no change in basis when there is a change in the method of computing statutory reserves, if, in the year of change, the computation of the FPR has not changed. The taxpayer thus contends that in Year 4, all that happened was a change in the computation of the statutory reserve limitation, and the change was not a change in basis in computing reserves.

The Internal Revenue Code does not expressly define the phrase "method of accounting." However, case law has held that the phrase includes "the consistent treatment of any recurring, material item, whether that treatment be correct or incorrect."



See Bank One Corp. v. Commissioner, 120 T.C. 174, 282 (2003), aff'd in part and vacated in part sub nom. J.P. Morgan Chase & Co. v. Commissioner, 458 F.3d 564 (7th Cir. 2006); H.F. Campbell Co. v. Commissioner, 53 T.C. 439, 447 (1969), aff'd 443 F.2d 965 (6th Cir. 1971).

Under Treas. Reg. § 1.446-1(e)(2)(ii)(a), a "material item" is "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime income or merely determines the taxable year in which taxable income is reported. Huffman v. Commissioner, 126 T.C. 322, 343 (2006), aff'd, 518 F.3d 357, 364-5 (6th Cir. 2008); See Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Knight Ridder v. United States, 743 F.2d 781, 798 (11<sup>th</sup> Cir. 1984); Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969); Rev. Proc. 91-31, 1991-1 C.B. 566. Treas. Reg. § 1.446-1(e)(2)(ii)(a) further provides that in most instances a method of accounting is not established for an item without a pattern of consistent treatment. Where a taxpayer has treated an item improperly, consistent treatment is shown by two or more years of application. See Rev. Rul. 90-38, 1990-1 C.B. 57.

An adjustment to the consistent treatment of an item that affects the timing for recognition of the item and does not permanently change lifetime income is a change in method of accounting. Huffman v. Commissioner, 518 F.3<sup>rd</sup> at 363. Conversely, Treas. Reg. § 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include adjustment of any item of income or deduction that "does not involve the proper time for the inclusion of the item of income or the taking of a deduction."

In general, if the taxpayer changes its method of accounting, section 481(a) requires the recognition of those adjustments that are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted.

The computation of life insurance reserves does not have a permanent effect on the taxpayer's lifetime taxable income, as any deduction for the increase in reserves will ultimately be offset by the release of the reserve and the recognition of this amount in income. American Mutual Life Insurance Co. v. United States, 267 F.3d 1344, 1350 (Fed. Cir. 2001). As noted by the lower court in that case, "By its explicit terms in 1959 as in 1984, [referencing the law before and after the enactment of section 807(d)] the initial deduction is zeroed out by the later addition to income. The release is an inescapable accounting entry, fully reversing a prior 'temporary' entry. Conceptually, at least, over time the tax impact of the reserve transaction is neutral. The tax item that has a 'permanent' impact is the deduction for death benefits, the actual paid liability." American Mutual Life Insurance Co. v. United States, 46 Fed. Cl. 445, 453 (2000). Therefore, the computation of life insurance reserves is a method of accounting.

Revenue Ruling 94-74 holds that the term "basis" in section 807(f) is interchangeable with the term "method" when describing the effects of a change in basis of computing reserves. Section 807(f) requires a specialized treatment for adjustments resulting from



a change in method of computing reserves, which otherwise would have been subject to the general tax rules under section 481 for changes in method of accounting.

American General Life Insurance Co. v. United States, 90-1 USTC ¶ 50,010 at 83,042 (M. Dist. Tenn. 1989) (interpreting former section 810(d), the predecessor to section 807(f)). The principles under which a change is determined to be a change in method of accounting to which section 481 applies, govern in determining whether an adjustment to reserves is a change in basis subject to section 807(f).

Prior to the enactment of section 807(d), with certain exceptions, life insurance tax reserves were computed using the statutory reserve method, and a change in basis occurred when there was a change in the basis of computing statutory reserves. Rev. Rul. 70-192, 1970-1 C.B. 153; Rev. Rul. 65-233, 1965-2 C.B. 228.

With the enactment of section 807(d), the required tax reserve is the FPR, unless the statutory reserve is lower. Section 807(d)(1) (flush language).<sup>1</sup> In the latter event, the amount of the reserve is limited to the statutory reserve. Thus, in applicable instances, both the FPR and the statutory reserve limitation determine the amount of the final tax reserve. The only impact of the final tax reserve computation is timing. Both the tax reserve computation and the statutory reserve limitation are components of the method of accounting for reserves, to the extent that the respective components are consistently applied, and determine the final tax reserve in any particular year.

When the statutory reserve "limitation" applies, the amount of the reserve is identical whether characterized as the tax reserve subject to the statutory reserve limitation, or the statutory reserve. The only impact is timing, and the effect on timing is the same as if the method of computing reserves was the statutory reserve method. As a result, the distinction between a statutory reserves "limitation" and a statutory reserves "method" is a distinction without a difference. When the limitation applies, statutory reserves determine the amount of the tax reserve, and thus a change in the statutory reserve method is a change in basis.

An analogous two-pronged accounting method is the inventory method known as the "lesser of cost or market." See Treas. Reg. § 1.471-4. In that instance, the method could similarly be characterized as the cost method of accounting, subject to a market "limitation." Indeed, the Supreme Court has described this method similarly: "From this language, the regulatory scheme is clear. The taxpayer must value inventory for tax purposes at cost unless the 'market' is lower." Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 535 (1979). Nevertheless, Section 481 applies when there is a change to either prong of the method. A change in the method of computing the cost of inventory is a change in method of accounting. Primo Pants v. Commissioner, 78 T.C. 705 (1982). When market is lower, a change in the method of computing the market value of inventory is a change in method of accounting. Brooks-Massey Dodge, Inc. v. Commissioner, 60 T.C. 884 (1973). In Superior Coach of Florida, Inc. v. Commissioner, 80 T.C. 895 (1983), a taxpayer using the lesser of cost or market method was required

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<sup>1</sup> The reserve for the rider at issue is not subject to a net surrender value floor.



to value its inventory at cost because it was unable to substantiate a lesser market value. The court held it was a change in method of accounting.

In Year 2, the taxpayer changed its computation of the federally prescribed reserve. This change is a change in method of computing reserves. The computation of the federally prescribed reserve impacts the proper time for the inclusion of the item in income or the taking of a deduction. However, because the change did not affect the amount of the reserve, the section 807(f)(1) amount was \$0.

In Year 4, there was an increase in reserves attributable to the fact that Taxpayer changed its method of computing the statutory reserve limitation. As of the end of Year 3, the correct under AG 33 were not taken into account in determining the amount of the final tax reserve. As of the end of Year 4, the correct were used in determining the amount of the final tax reserve. Using the correct for the statutory reserves under AG 33 is a change in basis of computing reserves. The difference between the two methods as of the end of Year 4 was a change in basis that must be recognized under section 807(f), beginning in Year 5.

The taxpayer counters by making two arguments in support of its position that the statutory reserve is not a component of the tax reserve method of accounting. It first cites language in the 1984 "Blue Book." Staff of Joint Committee on Taxation, 98<sup>th</sup> Cong. 2<sup>nd</sup> Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 603-604 (Comm. Print. 1984). Blue Book explanations do not qualify as legislative history and at best may provide persuasive material. See, United States v. Woods, 134 S.Ct. 557, 568 (2013) (Blue Books are "not a legitimate tool of statutory interpretation." (citation omitted)).

The Committee Print provides that changes in the net surrender value are not subject to section 807(f). The rationale offered is that "[c]hanges in the net surrender value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve but a current liability." The distinction made by the Joint Committee staff was thus between a liability for future obligations, which is taken into account through the reserve, and a liability for current obligations, which presumably would be taken into account (under their reasoning) through the accrued benefit deduction, when the reserve is released. In the view of the Joint Committee staff, since the net surrender value obligation would not independently be characterized as a reserve, its function as a floor in the reserve calculation was not sufficient to conclude that changes to the net surrender value were changes to the reserve.

The Joint Committee report does not make a similar observation with respect to the statutory reserve limitation, which, unlike the net surrender value, would qualify as a reserve apart from its role in the final tax reserve computation. Moreover, section 807(f) applies whenever there is a change in the basis for computing "any item referred to in subsection (c)," including 807(c)(1), life insurance reserves. Section 807(d), including section 807(d)(1), determines the amount of the life insurance reserve. Nothing in the



language of section 807(c)(1) or section 807(d) limits the "section 807(c)(1) item" to the federally prescribed reserve. Thus, a change in basis or method in determining life insurance reserves under section 807(d) would be subject to section 807(f) whether arising from changes in the method of computing the federally prescribed reserve or the final tax reserve computation, including the application of the statutory ceiling.

The taxpayer additionally argues, relying on Principal Mutual Life Insurance Co. v. United States, 48 Fed. Cl. 52 (2000), aff'd, 295 F.3<sup>rd</sup> 1241 (Fed. Cir. 2002), that statutory reserves are not included in section 807(f) changes in basis because they are merely amounts taken directly from the annual statement and are not "computed." The taxpayer misconstrues the analysis in that case, which in any event has no relevance to the issue at hand.

The issue in that case was the calculation of the limitation to the deduction for policyholder dividends under former section 809. The limitation took into account the "excess" of statutory reserves over tax reserves, and the issue was whether "statutory reserves," for purposes of determining the "excess", were subject to the adjustments required by section 811(d). The court held that statutory reserves were not separately computed for tax purposes. Rather, statutory reserves were computed for purposes established under state law and by the National Association of Insurance Commissioners (NAIC). 48 Fed. Cl. at 58. Thus they were not subject to adjustments that would apply to tax reserves.

As the adjustment in controversy concerned the computation of the "excess" of statutory reserves over tax reserves, it did not involve tax reserves for which the statutory reserve limitation applied. In any event, the case did not address changes in the computation of tax reserves, but only the limitations on the policyholder dividends deduction. Thus, the case has no bearing on the instant issue.

The implications of the taxpayer's argument is that a "book" method of accounting is not an accounting method, because it is calculated for book purposes by reference to rules not specified by the internal revenue code and once calculated for book, merely transcribed onto the tax return. That is clearly not the case. As indicated above, prior to 1984, the applicable method of accounting for life insurance tax reserves was the statutory reserve, computed for purposes established under state law and by the NAIC. Nevertheless, statutory reserves qualified as an accounting method, and changes in statutory reserves "transcribed" onto the tax return were changes in basis. See also Treas. Reg. § 1.446-1(a)(2) (the application of a method of accounting "which reflects the consistent application of generally accepted accounting principles in a particular trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.")

Accordingly the increase in the taxpayer's reserves in Year 4 to take into account the proper for statutory reserves was a change in basis subject to section 807(f).



CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call me if you have any further questions.

MICHAEL P. CORRADO  
Area Counsel  
(Heavy Manufacturing & Pharmaceuticals)

By: \_\_\_\_\_  
Diane D. Helfgott  
General Attorney, (Newark, Group 2)  
(Large Business & International)